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April 3, 2000

EX PARTE OR LATE FILED

BY HAND

Magalie R. Salas, Esq., Secretary
Federal Communications Commission
The Portals
445 Twelfth Street, S.W.
12th Street Lobby, TW-A325
Washington, D.C. 20554

Re: *CC Docket No. 98-184; Ex Parte Filing*

Dear Ms. Salas:

Enclosed are two copies of a letter from William P. Barr, with attachments, to be filed on the public record in the above-referenced docket. By copy of this letter, I am hand delivering this document to the persons listed below.

If you have any questions, please contact me.

Very truly yours,

Steven G. Bradbury

Steven G. Bradbury

Enclosure
cc (w/encl.): Dorothy Attwood
Robert Atkinson
Rebecca Benyon
James Bird
Michelle Carey
Kyle Dixon
Jordan Goldstein
Johanna Mikes
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April 3, 2000

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APR 3 2000

Ms. Magalie Roman Salas
Secretary
Federal Communications Commission
The Portals
445 Twelfth Street, S.W.
Washington, D.C. 20554

Re: ***GTE Corp. and Bell Atlantic Corp., CC Docket No. 98-184***

Dear Ms. Salas:

I am writing on behalf of Bell Atlantic and GTE in support of our proposal to spin off GTE Internetworking to an independent corporation 90% owned and controlled by public shareholders while retaining an option to increase our 10% equity interest in the future upon securing 271 relief. For the reasons outlined in our prior submissions and below, we believe our original proposal is both lawful and strongly in the public interest. In the interest of obtaining expeditious approval, however, we are modifying that proposal in certain respects described below to eliminate any conceivable remaining concerns. With these modifications, the proposal should be promptly approved.

OVERVIEW AND SUMMARY

Proposed DataCo Structure

Our proposal to eliminate the section 271 issues relating to GTE Internetworking ("GTE-I") was initially set forth in our Supplemental Filing of January 27, 2000 ("Supp. Filing"). Attached as Exhibit A to this letter is a comprehensive description of the proposal containing certain modifications we are now making. Briefly, that proposal, as modified, is as follows: GTE-I will become a separate public corporation ("DataCo") that will be 90% owned and controlled by public shareholders. The merged Bell Atlantic/GTE ("NewCo") will own only a 10% interest in DataCo with an option to increase its interest once it receives sufficient interLATA relief to operate the business.

Through an initial public offering, or "IPO," public shareholders will purchase shares of DataCo Class A common stock, which will initially carry 90% of the voting rights and the right to receive 90% of any dividends or other distributions. In exchange for relinquishing ownership and control of GTE-I, NewCo will receive shares of Class B stock of DataCo that will have 10% of the voting rights and the right to receive 10% of any dividends or other distributions. NewCo will also have the option, in the form of conversion rights, to increase its ownership in the future once it receives sufficient interLATA relief to operate the business. The Class B shares will be convertible into new shares that will represent up to 80% of the outstanding stock of DataCo.

The Bell Atlantic/GTE merger would close as soon as the IPO has been completed. (We are withdrawing our original proposal to close upon transfer of Class A shares to the investment banks.)

NewCo's conversion rights will be exercisable within five years from the closing of the merger. In order to exercise its conversion rights so as to own and control DataCo, NewCo must be able to operate DataCo in compliance with any section 271 restrictions. NewCo will thus have five years to eliminate those interLATA restrictions. If, by the end of five years, NewCo has eliminated such restrictions on at least 95% of its 271-restricted lines, NewCo may petition the Commission to obtain at least one more year to eliminate the remaining restrictions.

Just as GTE is free to sell GTE-I today to a third-party buyer, NewCo would have the right at any time to sell its shares. Contrary to AT&T's suggestion, the saleability of an option does not change its nature and make it a current equity interest, nor does it impact incentives to obtain 271 relief. Our proposal in fact creates powerful positive net incentives to obtain 271 relief, since DataCo is a unique asset that will be integral to NewCo's national data strategy. If it were to sell its DataCo shares to a third party, NewCo would be abandoning this opportunity.

Nevertheless, as a voluntary undertaking to further enhance incentives, we are proposing that NewCo would be foreclosed from retaining proceeds from such a sale to the extent they are attributable to DataCo's provision of interLATA services in states where NewCo has yet to obtain long distance relief.

Specifically, if NewCo sells its shares before it has eliminated interLATA restrictions on at least 50% of its restricted lines, NewCo will only be allowed to retain those sale proceeds equal to the amount it would have received if it had sold DataCo at the time of closing and reinvested the proceeds. Thus, NewCo would be no better off than if it had sold its interest in DataCo to a third party before closing the merger. If, on the other hand, NewCo sells its shares after achieving the 50% mark, then it will forgo the sale proceeds to the extent they represent gain attributable to those Bell Atlantic states in which 271 restrictions still apply.

Until NewCo exercises its option, DataCo will be independent of NewCo. The public shareholders will have 90% voting control, and DataCo will have an independent board of directors, initially consisting of 10 directors. One member will be the CEO of DataCo and eight of the remaining nine directors will be outside directors who will have no affiliation with Bell Atlantic or GTE. The tenth director will be elected by a class vote of the Class B shares and will not be eligible to serve as chairman. We are modifying our original proposal to provide that, following the IPO, during the next three annual elections, the board will be expanded to 13 members and a majority (at least seven) will be new members who will be nominated and elected to the board for the first time after the IPO. (*See* Exhibit B.)

NewCo's interests as a minority investor with an option to acquire a controlling interest in the future will be protected by certain reasonable investor safeguards. These are both typical of the rights commonly held by option holders or other prospective acquirers and modeled on investor protections that have regularly been permitted by the Commission. The applicants have modified their proposal by eliminating or paring back several of these investor safeguards. (*See* Exhibit C.)

The GTE-I business being placed in DataCo provides Internet backbone and related data services. DataCo does not provide traditional switched long-distance voice service. As will be discussed below, this substantially lessens any theoretical risk of discrimination, since DataCo is not highly dependent upon Bell company local exchange facilities. DataCo's business plans do not contemplate acquisition of a traditional switched long-distance voice provider. Bell Atlantic and GTE will agree that NewCo would not consent to DataCo's acquisition of a traditional switched long-distance voice provider unless and until the Commission has reviewed and approved such acquisition.

The DataCo solution will preserve the integrity and competitiveness of GTE-I's existing business while also preserving NewCo's ability (contingent on the necessary interLATA relief) eventually to acquire control of DataCo and bring to market the full range of long-term Internet and data benefits promised by the Bell Atlantic/GTE merger. In the meantime, this solution will enable customers to begin realizing immediately some of these important data benefits, since a significant portion of DataCo's business will be outside the Bell Atlantic region or in in-region states, such as New York, where Bell Atlantic has achieved 271 relief. Accordingly, NewCo will market DataCo services (or the two companies will market their services jointly) as and where permitted by law, pursuant to a marketing agreement that we are submitting to the Commission today. (A summary of that agreement is contained in Exhibit D.) NewCo will not participate in marketing any of DataCo's interLATA services in any 271-restricted state. All terms in the marketing agreement are non-exclusive and the agreement is one that both Bell Atlantic and GTE could enter into today with any similarly situated company.

Consistent with the fact that DataCo and NewCo will each be independent public corporations whose directors and officers will owe duties of care and loyalty to their respective shareholders, all other commercial interactions between the companies will also be conducted pursuant to commercially reasonable contracts. In particular, NewCo will provide certain necessary services to DataCo on a transitional basis, just as NewCo would need to do even if DataCo were divested to an unaffiliated third party purchaser. All of these transitional services contracts are for one year or less and are terminable at any time at DataCo's election without penalty. We are submitting copies of these contracts for the record, and they are summarized in Exhibit D.

Finally, we will agree to hire an independent auditor, acceptable to the Chief of the Common Carrier Bureau, to monitor NewCo's ongoing compliance with the terms of Exhibit A.

The Proposed Structure Is Lawful and Fully Satisfies Section 271

As I will discuss at length below, the DataCo proposal is fully consistent with the requirements of the Communications Act and is amply supported by basic legal principles and a host of precedents, including the Commission's own prior rulings and precedents from Judge Greene under the MFJ. All of these precedents establish that DataCo will not be an "affiliate" of NewCo. In particular, the consistent rule of law, repeatedly affirmed by the courts and this Commission, is that an option or other convertible interest, like NewCo's option in DataCo, does not constitute *per se* ownership or control. Moreover, all of the features of our proposal, including the 90% public voting control, the independent board and the contractually specified commercial relationships, will ensure that NewCo does not exercise actual control over DataCo. In support of our legal analysis is a Second Supplemental Declaration of Professor Ronald J. Gilson ("Gilson Second Supp. Decl."), attached hereto as Exhibit E.

None of the arguments offered by AT&T in opposition to this proposal have any force. AT&T cites no authority that undercuts the basic legal principle that options are not ownership. In the end, AT&T's arguments come down to a matter of policy, and only prove that the Commission's acceptance of the DataCo structure is a matter of discretion that turns on whether our proposal is consistent with the objectives of section 271.

The DataCo structure is manifestly consistent with the policies underlying section 271, and, indeed, it affirmatively advances those policies. This proposal will *increase* the net incentives of NewCo to complete the 271 process as soon as possible, since reacquiring ownership and control of DataCo in the near future is the key to NewCo's national data strategy. The Commission only recently recognized in the *Qwest/U S WEST Merger Order* that just such a prospect creates "powerful new incentives" to complete the 271 process. At the same time, our proposal creates a bigger "stick" to compel prompt 271 compliance, since the loss of the unique benefits offered by owning DataCo would be a blow to NewCo's long-term business plans.

Although no sale of NewCo's option could compensate for such a loss, the voluntary undertakings that we are now including in our proposal will enhance these positive incentives even further by expressly limiting NewCo's ability to realize value from such a sale in proportion to NewCo's progress in attaining 271 relief. This proposal, as modified, also ensures that NewCo will not receive any material benefits uniquely attributable to DataCo's interLATA operations in states where it has not yet received long distance relief.

Finally, the acceptance of our proposal holds no risk of creating a precedent that will lock the Commission in to approving other option arrangements that might be proposed by other Bell companies. The features of our proposal make it highly unlikely, as a practical matter, that any similar arrangement will be proposed in the foreseeable future, particularly one involving a large, integrated interexchange carrier, since, as part of our proposal, we are ceasing to offer traditional voice long-distance service in the Bell Atlantic region – something no large IXC could do. Moreover, the unique attributes of DataCo, and the important competitive role it plays in the Internet backbone market, provide ample grounds to distinguish this case from future cases in terms of the policies of section 271 and the public interest benefits of the Bell Atlantic/GTE merger.

DISCUSSION

I. Basic Legal and Policy Principles Fully Support Our DataCo Proposal.

It is time to clear away the fog generated by AT&T's multiple submissions and refocus on the core principles that should undergird the Commission's analysis of the DataCo proposal.

Sections 3(1) and 271 of the Communications Act provide that a regional Bell company may not "own" or "control" an entity that provides in-region interLATA service. The term "own" is defined to mean "to own an equity interest (or the equivalent thereof) of more than 10 percent." Under our proposal, NewCo's Class B shares will contain an option that, upon exercise in the future, would allow NewCo to acquire an equity interest up to 80%. In addressing whether NewCo's possession of this option is consistent with sections 3(1) and 271, it is useful to lay out an organizing structure for the analysis. Logically, there are two separate and distinct questions before the Commission:

(1) Whether the plain language of section 3(1)'s "affiliate" definition, on its face, mandates a conclusion that NewCo's option, *as a matter of law*, constitutes prohibited equity ownership or control, such that the Commission has no discretion to approve our DataCo structure?

(2) If the answer to the first question is no, the second question involves a *policy* judgment: Whether it is reasonable and appropriate for the Commission, in the exercise of its policy discretion, to accept the overall DataCo proposal on the ground that this proposal is consistent with, and even advances, the objectives of section 271?

As we demonstrate below, well-settled principles of law, as well as precedents in a host of contexts, including Commission and MFJ precedents, clearly establish that options do not constitute ownership or control. Thus, NewCo's option cannot constitute equity ownership or control *per se*. For the Commission to hold otherwise would require a substantial deviation from prior precedents.

Although AT&T has tried to clothe its arguments in *per se* terms – to argue that our option must be viewed as a violation of section 3(1)'s plain terms and that the Commission is foreclosed from considering 271 policies in evaluating our proposal, *see* AT&T March 10 Ex Parte at 1-2;

AT&T March 22 Ex Parte at 11-12 – AT&T's core arguments are, in fact, policy arguments in disguise. They rest not on the plain meaning of section 3(1), but on questions that call for exercise of the Commission's prudential discretion.

Once it is seen that AT&T's *per se* arguments are without force, the real question at issue is squarely within the policy discretion of the Commission: whether the DataCo structure is a reasonable and acceptable means to preserve and even enhance the objectives of section 271. Once the issue is properly framed, the fact that the DataCo structure is consistent with the purposes of section 271 (and, indeed, will advance those purposes by creating a powerful new incentive for NewCo to achieve 271 relief), while conferring on NewCo no ability to control the management of DataCo, fully justifies the Commission's acceptance of our proposal.

A. NewCo's option is not equity ownership.

1. Under the plain terms of section 3(1), NewCo's option is not an equity interest or its equivalent.

NewCo's right to convert its Class B shares into new shares representing up to an 80% interest in DataCo is a classic option.[1] It is black-letter law that options do not constitute present "ownership" or "equity," but only the right to acquire ownership in the future.[2] This is because an option (before exercise) confers no right to vote, to participate in corporate earnings, or to participate

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[1] *See* Declaration of Professor Ronald J. Gilson ¶¶ 14, 16 (Feb. 22, 2000) ("First Gilson Decl."), appended to Response of Bell Atlantic and GTE in Support of Proposal to Transfer GTE Internetworking to a Separate Corporation Owned and Controlled By Public Shareholders (filed Feb. 22, 2000) ("Response"); Supplemental Declaration of Professor Ronald J. Gilson ¶ 7 n.3 (Mar. 14, 2000) ("Gilson Supp. Decl."), appended to Bell Atlantic/GTE's March 14 Ex Parte; Gilson Second Supp. Decl. ¶ 3 & n.1.

[2] *See, e.g., Western Union Tel. Co. v. Brown*, 253 U.S. 101, 110 (1920) ("An option is a privilege given by the *owner* of property to another to buy the property at his election. It secures the privilege to buy and is not of itself a purchase. The owner does not sell his property; he gives to another the right to buy at his election.") (emphasis added); *O'Brien v. United Home Life Ins. Co. of Ind.*, 250 F.2d 483 (6th Cir. 1958); James on Option Contracts § 501 (1916) ("the weight of authority" "holds that an option contract to purchase does not vest any estate, legal or equitable, in the optionee prior to his election to purchase"); 12A Fletcher Cyclopedia of Private Corp. § 5575 (1993) ("An option to purchase stock does not vest in the prospective purchaser an equitable title to, or any interest or right in, the stock."); 18B Am. Jur. 2d *Corporations* § 1960 (1985) ("Since a stock option does not obligate the optionee to buy the shares offered, it gives him no right or title to such shares unless he accepts the offer in accordance with its terms . . ."). *See also* Supp. Filing at 35; Response at 8 n.8 (citing additional cases).

in dissolution proceeds[3] – the three traditional indicia of equity ownership. Gilson Second Supp. Decl. ¶ 3; First Gilson Decl. ¶ 10 n.5. It makes no difference whether the exercise price is fixed,[4] or whether, as here, exercise is accomplished through conversion of another instrument. First Gilson Decl. ¶ 14. For the same reason, the general rule is that option holders may not bring shareholder derivative suits because they lack the requisite "proprietary interest" in the corporation.[5] The bottom line is that options do not constitute ownership until they are exercised. First Gilson Decl. ¶ 19 ("only exercise or conversion transforms an option into equity").

Thus, the plain and ordinary meaning of "equity interest" in section 3(1) unambiguously excludes options, and the mere holding of an option cannot mean that NewCo owns an equity interest in DataCo. *See, e.g., Association of Flight Attendants v. USAir, Inc.*, 24 F.3d 1432, 1435 (D.C. Cir. 1994) ("USAir has no present *equity interest* in Shuttle, but it has an *option* to purchase a controlling interest in the company effective October 10, 1996.") (emphasis added). This has been the invariable principle in a host of contexts.[6]

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[3] First Gilson Decl. ¶ 16. *See also Bright v. Lord*, 51 Ind. 272 (1875) (stock option holder gets no dividends before exercise of option).

[4] 67 Am. Jur. 2d *Sales* § 136 (1985).

[5] *See Harff v. Kerkorian*, 324 A.2d 215, 219 (Del. Ch. 1974), *rev'd on other grounds*, 347 A.2d 133 (Del. Super. 1975); *Kusner v. First Pennsylvania*, 395 F. Supp. 276 (E.D. Pa. 1975), *rev'd on other grounds*, 531 F.2d 1234 (3d Cir. 1976); 19 Am. Jur. 2d *Corporations* § 2346 (1986).

[6] AT&T cites no cases to refute the general rule that an option to purchase property confers no right in the underlying property until exercised. Instead, AT&T futilely tries to distinguish the various cases we cited in our Response at 8 n.8. *See* AT&T March 22 Ex Parte at 13 n.20. AT&T's argument that "state" corporate law cases are irrelevant is puzzling, given that corporate law is generally a matter of *state* law. *See* BA/GTE March 14 Ex Parte at 9 n.4 (citing *Burks v. Lasker*, 441 U.S. 471, 478 (1979)). AT&T dismisses *Martin v. Schindley*, 442 S.E.2d 239 (Ga. 1994), and *Thacher v. Weston*, 83 N.E. 360, 361 (Mass. 1908), on the sole ground that those cases involved options to purchase *real* property rather than stock. But the fact that the general rule applies to *all* property and not just stock simply confirms that it is a *general* rule of black-letter law that options do not confer ownership. AT&T concedes that *Ball v. Overton Square, Inc.*, 731 S.W.2d 536 (Tenn. Ct. App. 1987), held that "an option to purchase stock does not vest in the prospective purchaser an equitable title to, or any interest or right in, the stock," *id.* at 540, but AT&T nonetheless professes it "ironic" that we rely on *Ball* because, in its view, that case "did not disagree" with the trial court's conclusion that "the option gave its holder 'control' over the firm." AT&T March 22 Ex Parte at 13 n.20. The only "irony" is that AT&T misreads as *failing* to disagree with the trial court the very portion of the *Ball* opinion in which the appellate court stated, "We disagree with the trial court's ruling," and vacated the trial court's judgment on this point. 731 S.W. 2d at 540-41 (vacating and remanding trial court judgment). Finally, AT&T finds it "unintelligible" that we rely on *Nerken v. Standard Oil Co.*, 810 F.2d 1230 (D.C. Cir. 1987), because that case turned on the meaning of the term "outstanding common stock" rather than on

(continued...)

This general principle of law – that options are not equity ownership until exercised – explains why the acquisition of an option, warrant or similar convertible interest does not trigger Hart-Scott-Rodino merger review under the antitrust laws. *See* 16 CFR § 802.31 (exempting acquisition of "convertible voting securities" from HSR reporting requirement). Only the "subsequent conversions" of such interests trigger review. *Id.*

Not surprisingly, the same principle pervades the Commission's own precedents. The Commission has consistently followed the traditional rule by finding that options, warrants and other convertible securities are not current ownership interests but only "potential future equity interests."[7] Accordingly, in all contexts where the Commission enforces ownership limits in order to safeguard competition, the Commission has consistently ruled that options and other convertible interests do not count as ownership. These include the Commission's CMRS spectrum cap rules,[8] its LEC/LMDS cross-ownership rules,[9] its application of section 310's foreign ownership ban,[10] its broadcast attribution rules,[11] and its cable attribution rules.[12]

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[6] (...continued)
"whether a prospective right to own stock is ownership under the law generally." AT&T March 22 Ex Parte at 13 n.20. As we explained in our prior submission, the passage of *Nerken* that AT&T cites also states the general rule that "one is not an owner of common stock prior to conversion of the preferred or before an option to buy has been exercised." 810 F.2d at 1232. And a later portion of *Nerken* that AT&T conveniently omits from its discussion goes on to hold – with respect to a different instrument – that the acquisition of an option to buy common stock does not constitute present ownership of the stock itself. *Id.*

[7] *Biennial Review of Spectrum Aggregation Limits*, Report and Order, WT Docket No. 98-205, ¶ 8 (Sept. 22, 1999). *See In re Woods Communications Group*, 12 FCC Rcd 14042, ¶¶ 13-14 (1997) (characterizing options as "future equity holdings" and "possible equity interests").

[8] 47 CFR § 20.6(d)(5) (CMRS spectrum cap rules) (excluding options, warrants and other conversion rights from attribution).

[9] *Id.* § 101.1003(e)(5) (LEC/LMDS cross-ownership rules) (same).

[10] See BBC *License Subsidiary*, 10 FCC Rcd 10968, ¶ 20 n.12 (1995) (applying the foreign ownership ban of 47 U.S.C. § 310(b)(4)) ("future interests, such as options and convertible rights, are not relevant to our alien ownership determinations until converted"); *In re GWI PCS, Inc.*, 12 FCC Rcd 6441, ¶ 10 (1997) (same); *In re DCR PCS, Inc.*, 11 FCC Rcd 16849, ¶ 24 (1996) (same).

[11] 47 CFR § 73.3555, Note 2(b) & (f) (broadcast attribution rules) (making clear that options, warrants and other convertible interests are not treated as *per se* ownership interests).

[12] *Id.* § 76.501, Note 2(e) (cable attribution rules) (same).

Finally, the general principle that options are not ownership also underlies the MFJ precedents we have cited (arguably the most relevant legal precedents for the issue at hand, since the MFJ was the direct legal antecedent to section 271). In a long line of cases, the Justice Department approved and Judge Greene allowed options and other conditional interests to be acquired by Bell companies in prohibited businesses, including interLATA businesses. *See* Supp. Filing at 40-43 (summarizing MFJ option precedents); *see also* Response at 12-13. The MFJ precedents alone are sufficient to establish that NewCo's option cannot be, *per se*, a prohibited equity interest for a BOC.

Against this mountain of consistent precedent, AT&T hangs much of its argument on the so-called "equity plus debt," or "ED," rule, adopted by the Commission as part of its cable and broadcast attribution rules.[13] In fact, the ED rule, far from undercutting the general principle that options do not constitute ownership, actually supports our point.

The ED rule, which counts debt as well as equity interests and uses a 33% safe harbor rather than the 10% mandated in section 3(1), is *not* a rule about *ownership*; it is a rule about the *capacity to influence* (and is thus more closely related to control, as I will explain in more depth later).[14] The Commission's discussion of options and the ED rule in footnote 329 of its *Cable Attribution Order* (on which AT&T places such great weight) only reinforces the point that the Commission generally does *not* count options as *ownership* (even options that are immediately convertible). The Commission was using section 3(1)'s affiliate definition on an interim basis in the cable context for purposes of the "LEC test," and Time Warner had argued that options and other convertible instruments that are convertible into voting stock *within 60 days* should be counted as *the "equivalent" of an "equity interest" within the meaning of section 3(1)* because the SEC defines such immediately convertible instruments to be "beneficial interests" (for control purposes) under the securities laws. Time Warner Comments at 8-9 (citing 17 CFR § 240.13d-3 and 15 U.S.C. § 78(*l*)-(n)). The Commission expressly *rejected* that argument and determined instead that options that are immediately exercisable do not equal equity ownership or its equivalent. *Cable Attribution Order* ¶ 129 n.329 ("[w]e disagree with Time Warner"). Thus, footnote 329 shows that even options that are immediately convertible into ownership and control by their holders (in contrast to the situation here, where NewCo's ability to take ownership will be contingent on 271 relief) are not

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[13] *See In re Review of the Commission's Regulations Governing Attribution of Broadcast and Cable/MDS Interests*, 14 FCC Rcd 12559, ¶¶ 35-65 (1999) ("*Broadcast Attribution Order*") (adopting original ED rule); 47 CFR § 73.3555, Note 2(j) (ED rule in broadcast context); *id.* § 76.501, Note 2(i) (ED rule in cable attribution context).

[14] *See Broadcast Attribution Order* ¶¶ 38, 40; *In re Implementation of 1992 Cable Act*, CS Docket No. 98-82, ¶¶ 83, 86, 90, 129 (1999) ("*Cable Attribution Order*").

considered *ownership* by the Commission, and are more properly addressed (if at all) under the *control* analysis.[15]

AT&T's remaining arguments on the issue of equity ownership are patently flawed. To accept them would require overthrowing the traditional rule about options and jettisoning all the prior precedents, including the Commission's.

AT&T's "definitional" argument. First, AT&T argues that NewCo's option must be an "equity interest" because another statute, the Securities Exchange Act of 1934, defines "equity security" for insider trading purposes to include options and convertible securities. Thus, AT&T points to a different term in a different statute that serves a very different purpose. *See generally* Gilson Supp. Decl. ¶¶ 4-16 (discussing at length the "entirely different" purposes of the securities laws); Gilson Second Supp. Decl. ¶ 8. Clearly, the fact that stock options are in certain circumstances regulated as equity securities by the SEC under its disclosure and insider trading rules does not mean that the holders of stock options *own* shares of the company before the options are exercised.[16] They do not, and courts have specifically held that the Securities Exchange Act cannot be read to suggest otherwise.[17]

AT&T's "valuation" argument. AT&T's second argument focuses on the expected market value of the public's Class A common stock. AT&T points to the fact that, because the markets will anticipate the eventual exercise of the Class B option, the public's 90% interest may tend to trade at a value that approximates 20% of the total enterprise value of DataCo. From this, AT&T argues that NewCo must currently own 80%. This argument confuses the valuation the market places on a security with the extent of the ownership rights the security confers. The market valuation will only reflect the expectation that *somebody* will eventually exercise NewCo's conversion rights. But

[15] When I address the issue of "control" in part I.B of this letter, I will discuss at greater length the Commission's apparent decision in footnote 329 to count such immediately convertible instruments under the ED rule for *control* purposes.

[16] Indeed, AT&T itself recognized that options are not ownership when it omitted any reference to MediaOne's option to acquire an additional interest in Time Warner Entertainment ("TWE") in describing MediaOne's "ownership interest" in TWE in its official filings with the Commission. Bell Atlantic/GTE March 14 Ex Parte at 4 n.2. Thus, when AT&T is under a legal duty to disclose truthfully to the Commission all "ownership interests" it may hold in a relevant entity, its disclosures reveal that AT&T does not really believe its own argument that options are equity interests by definition.

[17] *See Harff v. Kerkorian*, 324 A.2d 215, 220 (Del. Ch. 1974) ("As to the Securities Exchange Act of 1934, 15 U.S.C. Section 78c(a)(11) does define an 'equity security' to include all securities convertible in to stock. However, such definition is expressly limited to use within the Securities Exchange Act, and the rationale of the act and the cases interpreting the act do not warrant a broader application.") (quotation omitted), *rev'd on other grounds*, 347 A.2d 133 (Del. Super. 1975).

that person may not be NewCo; it may be a person who is not subject to 271 restrictions. When valuing outstanding public securities, markets will anticipate any dilution to which the securities may be subject from the future exercise of all options, warrants or other convertible interests. Thus, for example, in valuing the common stock of companies like GTE and Bell Atlantic, analysts will discount share values by the number of options issued to management. This practice certainly does not mean that the shareholders own less equity; nor does it mean that the option holders actually own the company to the extent of the discount.

AT&T's "saleability" argument. AT&T's final argument on ownership focuses on the market value of NewCo's option if sold. Because NewCo can capture the value of its option through a sale, AT&T claims that the option is really an equity interest.

This argument has two parts. First, AT&T maintains that there is no "contingency" to NewCo's option and therefore that it is not a true option. On this point, AT&T is wrong in both law and fact: That an option is vested and has positive value does not make it any less of an option in the eyes of the law. All that is necessary to render an instrument an option is that the holder retains the discretion to exercise.[18] An option is no less an option simply because it has value and can be sold; indeed, options are generally saleable unless otherwise provided.[19] Thus, AT&T's argument proves far too much and would indict all options as ownership. Furthermore, as a factual matter here, NewCo's ability to exercise its option and take ownership and control of DataCo manifestly *will be* contingent on the fulfillment of a substantial condition precedent – namely, securing the necessary relief from section 271's interLATA restrictions. (Although AT&T's "contingency" argument has no legal merit, the voluntary undertakings we have now made remove any conceivable basis to claim that NewCo is *certain* to receive the value of its option, since we have committed that NewCo will forgo proceeds from the sale of its shares – other than the amount it would have received if it had sold DataCo for cash and reinvested the proceeds – in the event it sells before attaining 271 relief on 50% of Bell Atlantic's lines. *See* Exhibit A.)

The second part of AT&T's saleability argument, just like its valuation argument discussed above, simply confuses the market value of an instrument with the extent of ownership rights conveyed by that instrument. AT&T contends that, because NewCo can sell its option and translate

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[18] *See McGuire v. Andre*, 259 Ala. 109, 114, 65 So. 2d 185, 189 (1953) ("the distinguishing feature of an option contract is that it imposes no binding obligation upon the person holding the option"); *Suburban Imp. Co. v. Scott Lumber Co.*, 59 F.2d 711 (4th Cir. 1932) (similar).

[19] *See* 12A Fletcher Cyclopedia of Private Corp. § 5575 (1993) ("The fact that . . . a large profit is expected on resale[] is immaterial so far as the validity of the option is concerned."). *See also id.* ("An option to purchase stock . . . is assignable."); Restatement (Second) of Contracts § 320 (1979); *McNamara v. Commissioner*, 210 F.2d 505 (7th Cir. 1954) (stock option assignable before exercise unless the terms of the instrument restrict its transfer or assignment).

its value into proceeds, the option is really the equivalent of a current equity interest. It is a bizarre concept of ownership advanced by AT&T: that NewCo would make itself more of an owner by selling its option and forever abandoning the possibility of ownership.

The Justice Department (and Judge Greene implicitly) rejected the argument, made then by MCI and others, that if a BOC held an option that could be *sold for market value*, the BOC would have an "immediate equity interest" in violation of the MFJ's interLATA restriction. *See* Supp. Filing at 42-43. This argument was rejected on the grounds that a BOC's *sale* of an option ensured that the BOC would never exercise it – and never hold the present ownership interest that would have triggered the MFJ prohibitions. *Id.* at 43 (quoting Ameritech argument). Similarly, the Commission's rejection, in footnote 329 of the *Cable Attribution Order*, of Time Warner's argument that options that are immediately convertible (*i.e.*, within 60 days) should count as current equity interests also confirms the point. If an option's immediate convertibility into voting stock does not make it a cognizable equity interest, then *a fortiori* the saleability of the option cannot do so.[20]

The fatal flaw in all of AT&T's arguments is the implicit equating of *value* with the extent of equity *ownership*. This flaw is exemplified by AT&T's facile reading of the phrase "equivalent" of an "equity interest" in section 3(1) to include any instrument that is "equal in value" to a corresponding equity interest. AT&T March 10 Ex Parte at 3. One thing is clear from the face of the statute, however: The phrase "equivalent" of an "equity interest" cannot mean anything *more* than interests that convey the same ownership and control rights as equity. *See* Gilson Second Supp. Decl. ¶¶ 11-12. It cannot simply mean anything that has the same value as an equity interest, since that would encompass traditional instruments that are plainly not equity, such as convertible debt (or even cash, for that matter). Any instrument, including an option, that is convertible into voting stock will have a value equal to the present value of the future ownership interest into which it is convertible, but that does not make the instrument, in substance, the "equivalent" of present equity ownership. To the extent there is ambiguity in the term "equivalent," moreover, the Commission plainly has the discretion to construe it in light of the purposes of section 271, which, as Professor Gilson points out, is obviously concerned not merely with *value* equivalence, but with *control* equivalence – the capacity to participate in and exert control over a prohibited interLATA business. *See* Gilson Supp. Decl. ¶¶ 23-28; Gilson Second Supp. Decl. ¶ 12.

In truth, AT&T's argument about value, in all its various forms, is not a legal, but a policy, argument under section 271. The underlying concern is that the market value of the option might

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[20] If it did, then the cash received from the sale of the option would itself constitute the equivalent of an equity interest, an absurd result. *See Harff v. Kerkorian*, *supra*, 324 A.2d at 220 ("That a bond is convertible at the sole option of its holder into stock should no more affect its essential quality of being a bond than should the fact that cash is convertible into stock effect the nature of cash. Any bond, or any property, for that matter, is convertible into stock through the intermediate step of converting it to cash."); *In re Migel's Will*, 71 Misc. 2d 640, 642 (N.Y. Sup. Ct. 1972) (same).

adversely affect the net incentives of the Bell company to pursue 271 relief because, through a sale of the option, the BOC could capture and retain appreciation in the value of a prohibited interLATA business. I demonstrate below that this policy argument is unpersuasive. It is sufficient here to establish that this argument utterly lacks force as a *per se* legal claim about whether options constitute equity ownership.

* * *

In sum, the plain terms of section 3(1) establish that NewCo's option is not an "equity interest" or its "equivalent," since any other interpretation would require the Commission to depart from general principles of law and the overwhelming weight of precedents, including its own. Thus, if AT&T were truly correct that equity ownership is a pure legal question that must be addressed within the four corners of section 3(1)'s "affiliate" definition, the debate would be over and we would win. At a minimum, in light of the general understanding that options are not equity ownership, it would plainly be a reasonable interpretation of section 3(1) to conclude that NewCo will not "own" an "equity interest (or the equivalent thereof) of more than 10 percent" in DataCo. As I discuss below, to the extent the issue is one that falls within the policy discretion of the Commission, and may be informed by the purposes of section 271, acceptance of the DataCo proposal would clearly be a reasonable and appropriate exercise of that discretion.

2. The conclusion that NewCo does not own DataCo is consistent with, and indeed furthers, the policies of section 271.

Once it is seen that the question of ownership involves a discretionary judgment in light of the policies of section 271, the case for approving the DataCo proposal is powerful.[21]

[21] As a general definition provision, section 3(1) does not itself supply any policy content, and thus the policy considerations that are relevant here are the underlying objectives of section 271. AT&T claims that because section 3(1) is a general definition that relates to several sections of the Act (including not only 271, but also dialing parity, pole attachment, interconnection and the regulation of such things as obscene calls, pay-per-call services and telemessaging), it must be given a single "uniform" interpretation and cannot be applied differently depending on the policies and purposes of the underlying provision at issue. AT&T March 22 Ex Parte at 11. If AT&T were right that section 3(1) must be construed devoid of policy content, we would necessarily prevail – not only because the plain meaning of section 3(1) supports us, but also because it would make no sense to extend these various other regulatory provisions to encompass option arrangements, which confer on the option holder no capacity to control the activity under regulation. AT&T, however, is wrong as a matter of statutory construction. Section 3(1) does not define the terms "equity interest" or its "equivalent"; therefore, the effect of section 3(1) is simply to incorporate by reference these terms into each separate provision where the word "affiliate" is used and to which 3(1) applies. A common term used in various sections of a statute can be given different meanings depending on the context and (continued...)

First, the direct effect of our proposal is to *increase* the net incentives of NewCo to complete the 271 process as soon as possible. As the only independent top-tier Internet backbone, DataCo is a unique asset, and the ultimate ability to reacquire ownership and control of DataCo is the driving force behind NewCo's national data strategy. The motivation to get DataCo back and realize the vertical synergies that can only come from integrating with DataCo will create, in other words, an even bigger "carrot" for NewCo to achieve 271 compliance. The unique value of achieving interLATA relief and integrating with DataCo will far outweigh for NewCo the cash value of selling its option, and thus NewCo will have a powerful overall net incentive to pursue 271 approvals. *See In re Qwest Communications Int'l, Inc. and U S WEST, Inc.*, CC Docket No. 99-272, ¶ 2 (rel. Mar. 10, 2000) ("*Qwest/U S WEST Order*") (recognizing that Qwest/U S WEST will have "powerful new incentives" to comply with section 271 to realize the maximum integrated value of Qwest's national network).

Second, the risk to NewCo of losing DataCo forever by failing to achieve interLATA relief within five years will also create a much bigger "stick" to ensure continued progress in the 271 process. Because of the central importance of DataCo to NewCo's national data strategy, and because of the unique and irreproducible position occupied by DataCo among peering Internet backbones, any loss of DataCo, whether through a sale of NewCo's option or otherwise, would be unacceptable blow to NewCo's business.

Third, as we explained in our Supplemental Filing and our Response, there is no significant risk of discrimination here. As a practical matter, discrimination by NewCo in favor of DataCo is highly implausible and would be readily detectable. *See* Declaration of Raymond F. Albers (filed Feb. 22, 2000) (attached to our Response). Moreover, the nature of the DataCo Internet business, which is marketed to enterprise and ISP customers, not consumers, and which relies primarily on special access circuits, rather than local loops, raises far fewer concerns, in terms of its dependence on non-competitive local exchange facilities, than would a traditional consumer-oriented voice long-distance service. *See* Supp. Filing at 50-51; Response at 28-29. Finally, NewCo's need to obtain 271 relief in order to acquire ownership and control of DataCo would make it irrational for NewCo to undertake any strategy of discriminating in favor of DataCo, since any such conduct would directly put at risk NewCo's ability to satisfy the requirements of section 271 and ultimately to

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[21] (...continued)
purposes of the particular sections where it is applied. *See, e.g., Atlantic Cleaners & Dyers v. United States*, 286 U.S. 427, 433 (1932); *United States v. SCS Business & Tech. Inst.*, 173 F.3d 870, 881 n.15 (D.C. Cir. 1999). That is all the more true in this case because of the Commission's *Chevron* discretion. *See, e.g., U S WEST Communications, Inc. v. FCC*, 177 F.3d 1057, 1059-60 (D.C. Cir. 1999); *Abbott Labs. v. Young*, 920 F.2d 984, 987 (D.C. Cir. 1990). AT&T all but concedes this point when it acknowledges that the meaning of the term "control" – which also appears in 3(1)'s definition of "affiliate" – varies depending on context and "totality of circumstances." *See* Coffee Decl. ¶ 9 ("control" is "a question of fact that depends on the totality of the circumstances"); AT&T March 10 Ex Parte at 9-12.

realize its national data synergies. Judge Greene applied the very same reasoning when he concluded that the existence of the MFJ waiver review process and the requirement that a BOC obtain a waiver from the court before exercising an option to acquire an interLATA business would alleviate the risk of discrimination because any such conduct "would almost certainly be made known to the Court during any subsequent waiver proceedings."[22]

AT&T's only argument in the face of these positive 271 benefits is to assert that NewCo's ability to sell its option, examined in isolation, will create an incremental incentive not to comply with 271. *See* AT&T March 22 Ex Parte at 9-10. That cannot be the appropriate test. What matters, clearly, is the overall balance of incentives, as described above.

Moreover, it would not violate the purposes of section 271 for NewCo to realize a gain from selling its option. The 271 interLATA restriction is aimed at precluding BOCs from receiving the specific benefits associated with a LEC's ability to bundle local and long-distance products together, and is not a punitive statute aimed simply at precluding BOCs from receiving value from passive or conditional investments in interLATA businesses. *See AT&T v. Ameritech Corp.*, 13 FCC Rcd 21438, ¶¶ 5, 36-37 (1998). After all, the same aggregate gain could be realized from a 10% investment in each of eight different Internet companies – an investment strategy expressly authorized by sections 3(1) and 271. In addition, GTE could sell DataCo free and clear today, and if it did so, NewCo would realize the present value of any expected future appreciation of the business. Similarly, in theory, Bell Atlantic could transfer for value its executory option to acquire GTE and thus realize, in the sale price of that option, the value of any appreciation in the DataCo assets that may have built up during the past 20 months since Bell Atlantic and GTE entered into their merger agreement. Finally, of course, Bell Atlantic could receive a similar return simply from a passive investment in an index or mutual fund targeted at high-growth Internet stocks.

The economic reality is the same in all of these examples: Bell Atlantic would receive the "benefit" of the gain in appreciation of a prohibited interLATA business. Yet no one could argue that Bell Atlantic had realized that gain through the sort of "participation" or "involvement" in the prohibited businesses that 271 precludes. *See AT&T v. Ameritech*, 13 FCC Rcd 21438, ¶¶ 36-37 (section 271 prohibits a BOC's unauthorized "participat[ion]" or "involvement" in long distance markets and the receipt of "material benefits . . . uniquely associated with the ability to include a long distance component in a combined service offering"). In other words, 271 is concerned with *participation and control*, not merely *value*. Gilson Supp. Decl. ¶ 26. Thus, the receipt of market value or gain does not, in and of itself, amount to the improper provision of interLATA service through an "affiliate" in violation of section 271.

[22] *United States v. Western Elec. Co.*, No. 82-0192, slip op. at 7 (D.D.C. Aug. 7, 1986).

This conclusion is only strengthened by the voluntary undertakings we have now included in our DataCo proposal. We believe our original proposal was more than sufficient to justify the Commission's exercise of its policy discretion to approve the DataCo structure. Nevertheless, to the extent there remains any residual concern stemming from NewCo's ability to receive market value from the sale of its option in DataCo, any such concern is dispelled by our voluntary commitment that if NewCo sells its stock, it will forgo the benefits of DataCo's appreciation in proportion to NewCo's failure to obtain 271 relief. Moreover, NewCo will receive no benefits at all from DataCo's appreciation if it sells its option before it has attained 271 relief for more than 50% of Bell Atlantic's lines. These undertakings substantially enhance the already powerful incentives our proposal creates for NewCo to open its markets and receive 271 relief, and thus remove any conceivable basis to claim that NewCo will improperly "own" DataCo by virtue of its ability to sell its interest for value.

B. NewCo will not control DataCo.

As the Commission has repeatedly affirmed, and AT&T concedes, the question of control involves a fact-specific, case-by-case analysis. *See* AT&T March 10 Ex Parte at 9-12; Coffee Decl. ¶ 9 ("control" is "a question of fact that depends on the totality of the circumstances"). There can be no argument that as a matter of law an option such as NewCo's constitutes "control" *per se.* There is no legal authority for a general rule that options always equate with control, and, indeed, AT&T makes no such argument. Accordingly, the issue of control inherently involves the exercise of judgment and policy discretion by the Commission.

Here, our proposal includes several special features that should put to rest any policy concern about prohibited control. These include that DataCo will be 90% controlled by public shareholders and will be operated by an independent board that owes its fiduciary duties to the public shareholders. In addition, NewCo's relationships with DataCo will all be contractually specified. The additional undertakings we are making today diminish even further any theoretical risk of control by (1) modifying the board selection process to ensure that within three years a majority of DataCo's board will consist of new directors who were not originally installed by GTE, and (2) altering or eliminating several aspects of NewCo's investor safeguards that have been the focus of AT&T's objections.

In addition, we are separately submitting today for the record copies of the contracts that will govern commercial relations between NewCo and DataCo, and we are agreeing to the appointment of an independent auditor to monitor the implementation of these contracts. The marketing agreement between NewCo and DataCo complies in all respects with section 271, is non-exclusive and contains commercially reasonable terms that both GTE and Bell Atlantic could agree to with any third party Internet company. The transitional services contracts relate to services that NewCo would need to provide to DataCo even in the event of a complete divestiture; they are for one-year terms or less and are all terminable by DataCo at its election and without penalty.

All of these points, taken together, are sufficient to dispel any possible suggestion that NewCo will actually exercise control over the day-to-day management of DataCo.[23]

AT&T suggests that NewCo will somehow indirectly control DataCo simply by holding its option (that is, that DataCo's management will feel obliged to operate DataCo for the primary benefit of NewCo simply because of NewCo's option). *See* AT&T March 22 Ex Parte at 4, 19-20. That claim is at war with its earlier saleability argument: a saleable option should not give *NewCo* any special degree of control relative to any other entity that might acquire the option from NewCo. In other words, any notion of *control* must be specific to a particular *holder* of the option. The fact that NewCo may well choose to sell the option to another holder, as AT&T argues, means that it cannot be certain NewCo will ever exercise the option, which in turn will make it far less likely that DataCo's board and management team will feel beholden to NewCo.

Furthermore, the fact that NewCo must first satisfy the condition precedent of securing necessary relief from the 271 restrictions before it may own and operate DataCo means, at a minimum, that its conversion to an 80% owner will not happen in the near future. This added factor of a substantial and uncertain period of delay before NewCo will be in a position to take ownership and control will make it even less likely that DataCo's management will do the bidding of NewCo in the day-to-day operations of the company.

AT&T's last argument in support of the notion that NewCo's option will confer control is based on footnote 329 in the Commission's *Cable Attribution Order*. There (accepting, for the sake of argument, AT&T's interpretation of that footnote), the Commission appeared to suggest that options or other instruments that are immediately convertible into voting stock (*i.e.*, within 60 days)

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[23] In his latest declaration, Professor Coffee has switched ground away from the Securities Acts of 1933 and 1934, and away from the definition of "equity security," and now bases his discussion on isolated SEC cases assertedly addressing questions of "control" under the Public Utility Holding Company Act of 1935 – at statute that is now "mostly dismantled," as Professor Coffee himself acknowledges, and that, in any event, had "radically different purposes" from the Communications Act, Gilson Second Supp. ¶ 10. Specifically, Professor Coffee relies on a statement from the leading treatise on securities law that "[m]ost of the early SEC control cases arose under" that statute. Coffee Supp. Decl. ¶ 3 (citing Loss & Seligman, *Securities Regulation* (3d ed. 1990)). What he fails to say, however, is that the very same paragraph he quotes from Loss & Seligman goes on to say that "[i]n these cases, however, the accent was on 'controlling influence,' which the Commission and the courts said meant *'something less in the form of influence over the management or policies of a company than 'control' of a company.'"* Loss & Seligman at 1711 (emphasis added). Moreover, the same treatise also makes clear that even under the securities laws, "the context [for applying the concept of 'control'] – perhaps also the meaning of the concept – varies from statute to statute and sometimes within a particular statute." *Id.* at 1691.

would be considered in applying the "ED exception."[24] (As noted above, the ED exception is intended to address the potential for *control*; it is not a rule about *equity ownership.*) It is evident for several reasons that this prudential exception to the Commission's ordinary attribution rules (even accepting AT&T's reading of the rules) does not suggest that the Commission should or must reflexively apply the same exception to NewCo's option.

First, the Commission made it clear in crafting the ED exception that it was context-specific. It was warranted, according to the Commission, by the particular structures of the cable and broadcast industries, where it is common for distributors and programmers to share a variety of interrelated interests.[25] It was also warranted by the particular policy concern arising in the programming context that a party's ability to aggregate a variety of generally non-attributable interests carries a "potential for influence" that "may undermine the diversity of voices we seek to promote." *Cable Attribution Order* ¶ 83. There are no comparable concerns here.

Second, the ED exception cannot properly apply in this proceeding because it was adopted to address something less than actual control (and all parties here concur that section 3(1) requires actual control). In particular, the ED exception was expressly designed to capture interests that confer on their holders a level of "influence" *falling short of "control."*[26]

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[24] *See Cable Attribution Order* ¶ 129 n.329.

[25] *See Broadcast Attribution Order* ¶ 40 ("The current attribution exemptions are too broad with respect to certain currently non-attributable interests held by major program suppliers and same-market broadcasters, thus permitting them to wield a level of influence that should be subject to limitation by the multiple ownership rules."); *Cable Attribution Order* ¶ 82 ("We will tailor the [ED exception] to address the structure of the cable industry and to serve the particular purposes of each of the substantive cable rules at issue in this proceeding."); *id.* ¶ 90 (ED exception is justified in cable context in part because it is common for "cable operators to form combinations with one another across markets, as established in this record, in ways that the broadcast industry does not" and "[b]ecause of this market structure, if an MSO has a significant ED interest in a system, that interest enables the MSO to significantly influence or control a cable system's core functions, such as programming, the heart of the horizontal ownership rule" and "[t]hus, the ED interest by itself implicates the concerns of the rules without the addition of an additional prong [such as is required in the broadcast context]").

[26] *Broadcast Attribution Order* ¶ 38 (rejecting the argument that the ED exception should incorporate a 50% threshold "based on a control concept" and concluding instead that "attribution [under the ED exception] is not limited to relationships that permit control, but also extends to relationships that permit sufficient influence over core operations of the licensee such that they should be subject to the multiple ownership rules"); *Cable Attribution Order* ¶ 86 ("Our goal [in adopting the 33% ED exception] is not merely to attribute interests with the potential to control but also those with a realistic potential to exert significant influence."); *see id.* ¶ 129 (applying the ED exception in the particular context of the "LEC test"

(continued...)

Third, in adopting the ED exception, the Commission was exercising its general rulemaking authority and was very careful in doing so to preserve its discretion to vary from the exception on a case-by-case basis depending on particular circumstances and unique public interest considerations.[27] In the present case, where the Commission is addressing, in the context of a particular license transfer adjudication, an issue of first impression under sections 3(1) and 271 concerning the specific policy implications of allowing NewCo to hold a future interest in DataCo, it would make no sense whatsoever for the Commission to hamstring the exercise of its own public interest discretion in this or future cases by reflexively importing from the broadcast and cable contexts the industry-specific ED exception, instead of employing a case-specific and discretionary analysis of control that is informed by the policy concerns relevant to section 271. In other words, the Commission would be well within its discretion to apply the general rule to our option rather than a specialized exception developed in a different context.

Fourth, the very footnote 329 of the *Cable Attribution Order* to which AT&T ascribes so much weight conclusively establishes that the ED exception can have no logical application to the DataCo option at issue here. As noted above, footnote 329 was responding to a suggestion from Time Warner that "options, warrants, and convertible debentures should generally be treated as beneficial interests under our rules creating an attribution simply because the SEC defines them to be beneficial interests *if their owner can obtain voting stock through these securities within 60 days.*" *Cable Attribution Order* ¶ 129 n.329 (emphasis added) (citing 17 CFR § 240.13d-3 and 15 U.S.C. § 78(*l*)-(n)). The SEC's Rule 13d-3 definition of "beneficial ownership" is designed to capture the ability to control the voting or disposition of securities,[28] and the 60-day rule reflects the SEC's conclusion that securities convertible into voting stock within 60 days provide an imminent – as opposed to attenuated – opportunity for the holder to exercise influence or control over the

[26] (...continued)
on the ground that "an ED investment, given its size, by a LEC gives an MVPD" not control but "significant *access to the resources of a LEC*") (emphasis added).

[27] *Cable Attribution Order* ¶ 92 ("We believe that a bright-line ED test is superior to a case-by-case analysis because it permits the planning of financial transactions and minimizes regulatory costs. *Nevertheless, we retain discretion to review cases that present unique issues where the public interest requires such a review.*") (emphasis added); *Broadcast Attribution Order* ¶ 44 ("Of course, we retain discretion to review individual cases that present unusual issues on a case-by-case basis where it would serve the public interest to conduct such a review.").

[28] Interpretive Release on Rules Applicable to Insider Reporting and Trading, Release No. 34-18114, Fed. Sec. L. Rep. ¶ 26,062 n.17 (Sep. 23, 1981) (Rule 13d-3 "emphasizes the ability to control or influence the voting or disposition of" securities).

underlying securities.[29] The Commission stated that "[w]e do not believe that *these types of securities* [*i.e.*, securities that can be converted into voting stock within 60 days] demonstrate the type of current, active participation by a LEC envisioned by the LEC test, unless the amount of *these securities* that an investor holds is more than 33% of the total assets of a company." *Cable Attribution Order* ¶ 129 n.329 (emphasis added). Read in the context of the argument urged by Time Warner, to which the Commission was responding, footnote 329 implicitly indicates that the only circumstances where an option, warrant or convertible debenture might rationally be counted under the ED exception (even assuming that were allowed by the terms of the relevant attribution rules) is where the instrument is convertible into voting stock by a particular holder *within 60 days* (thus raising the possibility that that particular holder might have the potential to exert the sort of current influence the ED exception was intended to address).

Here, NewCo will decidedly *not be able to convert its option and take control of DataCo within 60 days* because NewCo's ability to do so will be directly contingent upon securing the necessary 271 relief, a condition precedent that will place a significant and uncertain time barrier on its ability to convert into a greater equity position. Indeed, even under SEC Rule 13d-3 – which AT&T essentially seeks to apply here – courts hold that an option or convertible security held by someone who cannot exercise it without first obtaining regulatory approval does not confer "beneficial ownership" within the meaning of Rule 13d-3.[30] Once again, the presence of this significant contingency on the exercise of NewCo's option interest alleviates any hypothetical concern that by holding the option, NewCo will be able to exert indirect control over the day-to-day management of DataCo.

II. Approval of the DataCo Structure Will Not Compel the Commission to Approve Any and All Option Arrangements Proposed By Bell Companies in Future Cases.

Finally, the approval of our particular DataCo proposal will not create a binding precedent compelling the Commission in future cases to approve other option arrangements that might, in theory, be proposed by other Bell companies. Three questions are relevant in assessing the potential precedential effect of our proposal:

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[29] *See* Filing and Disclosure Requirement Relating to Beneficial Ownership, Exchange Act Release No. 14,692, Fed. Sec. L. Rep. ¶ 81,571, at 80,310 (Apr. 21, 1978) ("The Commission is . . . mindful that as the point in time [at] which the right to acquire may come to fruition is extended into the future, the . . . right's ability to influence control is correspondingly attenuated. When sixty days or less are left until the right to acquire may be exercised, the Commission believes that the ability of the holder of such right to effect control is sufficient to warrant the imposition of an obligation to file under Rule 13d-1.").

[30] *See, e.g., Levner v. Prince Alwaleed*, 61 F.3d 8, 9-10 (2d Cir. 1995) (non-voting convertible preferred stock); *Transcon Lines v. A.G. Becker*, 470 F. Supp. 356, 369-71 (S.D.N.Y. 1979) (option).

(1) Are there practical considerations that make it unlikely that other Bell companies will propose substantially similar option arrangements?

(2) Are there case-specific facts about our proposal that distinguish it in terms of the policies and purposes of section 271?

(3) Are there unique attributes to DataCo and the Bell Atlantic/GTE merger that distinguish this case in terms of the Commission's general public interest review?

The answer to all three questions is yes.

First, as a practical matter, it is highly unlikely that a Bell company in the future would propose an option arrangement that is similar in material respects to our DataCo proposal. Here, GTE is voluntarily exiting from the business of providing traditional voice long-distance service to consumers within the Bell Atlantic region, and the DataCo proposal is limited to Internet backbone and related data and private line services. Thus, to be on all fours with our proposal, any arrangement proposed in the future could not include traditional consumer voice long-distance service. This limitation alone will make it highly unlikely that a similar proposal would be made involving a large interexchange carrier, such as Sprint, whose Internet and data businesses are thoroughly integrated with its traditional voice long-distance offerings. Shutting down Sprint's consumer long-distance service within an entire Bell region would not be a practical alternative (and, in any event, would be inconsistent with the public interest).

Similar practical considerations also make it unlikely that a smaller, independent Internet or data business that is not integrated with a larger IXC would enter into an option arrangement with a Bell company similar to the pre-paid option we are proposing. For the typical small Internet company, much of its value as a business comes from the prospect that it may be acquired. Such a company will not tie itself up in a long-term option arrangement that is subject to a substantial contingency without receiving the full value of the business up front. No Bell company, on the other hand, would be in a position to satisfy that requirement in the absence of the sort of larger merger synergies involved with the Bell Atlantic/GTE merger, because all of the value to the BOC of the option arrangement would be contingent and in the future, due to the restrictions imposed by 271. The Bell company's ability to offer value to the Internet company's shareholders, moreover, would be reduced even further if the BOC were to agree to the additional terms we are now including in our voluntary undertakings – terms that substantially limit the ability of the BOC to realize value from a sale of the option depending on the extent of 271 progress. These factors will make it highly unlikely that an Internet business that might otherwise wish to be purchased by a BOC could agree to such a pre-paid option arrangement, since the arrangement could never provide adequate purchase value to shareholders in the absence of broader merger synergies.

Second, the specific characteristics of DataCo make our proposal distinguishable from any future case in terms of the policies of section 271. As we have repeatedly emphasized, DataCo enjoys unique status as the only independent, top-tier Internet backbone network. This unique status means that NewCo will have an even greater incentive to fulfill the obligations of section 271 in order to secure a platform for immediate entry into the top ranks of peering Internet backbones. NewCo is unlikely to shirk its duties under 271 in favor of selling its option, since the cash value of the option could never compensate for the loss of DataCo's unique position on the Internet (a position that will be difficult to reproduce through other means). Given the unique status of DataCo, no other combination in the foreseeable future is likely to present the same positive incentives under section 271. In addition, the nature of the DataCo business, which is limited to the provision of Internet and related data services for enterprise and ISP customers, presents a far lower theoretical risk of discrimination than would a more traditional consumer-oriented long-distance business. To the extent any future option arrangement that might be proposed involves a different form of long distance service, the theoretical risks of discrimination would be different, and hence also the policy implications of the proposal for purposes of section 271.

Third, the unique attributes of DataCo and the Bell Atlantic/GTE merger distinguish this case from possible future cases in terms of the Commission's public interest standard. One direct benefit of our proposal is the preservation of DataCo as a strong, independent backbone operator and thus the protection of competition in the Internet backbone market in general. *See MCI/WorldCom Merger Order*, CC Docket No. 97-211, ¶¶ 142-61 (Sep. 14, 1998) (summarizing the competitive concerns raised by the aggregation of top-tier Internet backbones in the hands of a small number of IXCs). By preserving the ability of NewCo to reacquire DataCo and achieve the substantial vertical synergies of integrating Bell Atlantic's customer base with DataCo's backbone facilities, and by allowing DataCo to realize a portion of those benefits immediately (as and where permitted by section 271) through a contractual marketing arrangement with NewCo, our proposal, in the context of this merger, will produce unique and compelling public interest benefits. These benefits are unlikely to be reproduced by any future option proposal or merger.

CONCLUSION

For all of the foregoing reasons, and those contained in our Supplemental Filing, Response and March 14 Ex Parte, Bell Atlantic and GTE respectfully request that the Commission accept the DataCo proposal, as set forth in Exhibit A.

Respectfully submitted,

William P. Barr

cc: Dorothy Attwood
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